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WHAT ARE THE FUTURE PROSPECTS FOR THE THIRD WORLD?
Current Problems and Conclusions for Development Co-operation

by

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I. *The (Hopeless?) Situation of the Developing Countries*

In the early nineties, most developing countries are confronted with a number of serious problems¹:

- An ever increasing number of people in the Third World live below the poverty line. The income of these people is not sufficient to cover the minimum requirements of food and other basic needs².
- Surplus food production in many industrialized countries (especially in the EC) contrasts with insufficient food production in many developing countries, mainly in Africa.
- Owing to the continuing population growth, there is no improvement in the nutritional situation in many parts of the Third World, even with increasing agricultural production.
- Attempts to alleviate the food shortage frequently exacerbate environmental problems. Particularly in areas where the intensification of agricultural production suffers from the lack of foreign exchange and equipment, there is evidence of increasing overworking of the soil, the extension of farming to marginal locations and lasting damage to natural resources.
- It is a widely-held view that the destructive exploitation of natural resources, especially in those developing countries with tropical rain forests, is partly a result of the continuing problems in servicing foreign debt³. The argument is that in order to be in a position to actually raise the money required for servicing external debt, these countries increasingly turn to the export of tropical wood and meat (for the production of which the rain forests are cleared).

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- Although the overall share of the developing countries in world exports did not fall any further in the late eighties (1988: about 20%), the share of the poorest countries has been in continuous decline (from almost 2% in the early fifties to 0.3% in 1987). The primary reasons given for this are falling and fluctuating commodity prices⁴.
- In the vast majority of developing countries, high trade deficits can hardly be financed any longer. In particular, private lending to the Third World has virtually dried up⁵. Foreign direct investment emanating from industrialized countries is being increasingly channelled into other industrialized countries instead of developing countries⁶. Increasing development aid by the donor countries has fallen well short of filling the gap left by the decline in private capital transfers.

The general consensus of opinion is that the cumulative weight of these problems puts increasing pressure for structural reform on the developing countries concerned. Indeed, some of them have implemented far-reaching economic reforms (e.g. Mexico). In other cases, however, comprehensive and consistent structural reforms have failed because of internal resistance, or because promises of reform were not regarded as credible⁷. One of the main reasons for enforcement problems was the inability to achieve a social consensus on the distribution of the short-term adjustment costs which typically occur with structural reforms. Problems of credibility have arisen because of the previous failure of many half-hearted attempts at reform, resulting in lasting damage to the confidence of the economic actors in the capability and determination of the governments.

In view of this situation, it is hardly surprising that the pessimists are currently riding high in the stakes of assessing the economic prospects of the Third World. They regard it as a virtual impossibility that the problems discussed here will prove easier to solve in the future than is currently the case. On the contrary, they believe that in view of the radical structural changes in central and eastern Europe, the efforts towards European integration and also German unification, the developing countries will finally be shunted onto the sidelines. It would certainly be wrong to reject such fears out of hand. However, on closer analysis they prove to be undifferentiated and solely concentrated on the risks of international economic developments. What is more likely is that the changes in the international environment will stimulate a further differentiation within the Third World. The following discussion will give the reasons for this hypothesis by way of evaluating the opportunities open to developing countries in the newly emerging international division of labour. Subsequently, some central problems of specific groups of countries will be discussed and conclusions for development policy pointed out.

II. *The Developing Countries on the Sidelines?*

The collapse of socialist regimes in central and eastern Europe, the integration of western Europe as a result of the single European market and later monetary union, and further liberalization of world trade within the framework of the Uruguay Round of GATT, will effect far-reaching changes in the world economy in the nineties⁸. These factors will also partly determine the growth and development chances of the Third World. Although the Third World countries are not directly affected by the events in eastern Europe or integration of the EC, many observers – especially within the developing countries – see severe disadvantages arising for these countries. Fears are expressed primarily in three areas: foreign trade, development aid and the availability of private capital.

- As concerns foreign trade, it is argued that East European suppliers are likely to become additional competitors for the developing countries on world markets. Trade preferences for East European countries would then not only narrow the preference margins of the developing countries, but also, because of the keener competition, further reduce the developing countries' sales opportunities, especially in EC markets. This would be all the more the case if the single European market were to be accompanied by new trade barriers against the third world ("Fortress Europe").
- Despite contrary official assertions, government support for German unification and the restructuring of COMECON economies threatens to lead to at least a relative reduction in development aid from major donors, especially in Europe. Because of the concentration of public interest on Eastern Europe, the structural reforms of developing countries could be seriously hindered or even prevented as a result of the lack of foreign finance. The income gap between the industrialized and the developing countries could then widen.
- Even private capital, in the form of bank loans and direct investment, could be increasingly diverted from developing countries and concentrated in Europe as a result of EC integration and the reforms in Eastern Europe. Private venture capital would then be even scarcer in the Third World than it is now, with the consequence that it would be considerably more difficult to introduce more efficient economic coordination mechanisms.

However, such generalized fears ignore the fact that developing countries have, to varying degrees, already managed to adjust to external shocks in the past. The considerable differentiation within the Third World – the disparities in income and growth amongst developing countries are more pronounced

than the much vaunted income gap between industrialized and developing countries – can be traced back primarily to this variation in adjustment flexibility. At the opening of the nineties, the developing countries can be roughly divided into three groups: rapid progress has been made mainly by those countries which have opened up at least partially to the international division of labour and which have been shrewd in their debt management. In contrast, most of the heavily indebted countries, mainly in Latin America, have not managed to translate their locational advantages into any significant growth in income. The prime reasons for this are the failure to tackle structural adjustment problems in the seventies and the subsequent failure to implement economic reforms to catch up on the required restructuring. The third group includes the similarly heavily indebted Sub-Saharan countries in Africa, which can be characterized as being in a state of political decay and of continued decline of their development potential and the underlying institutional framework.

It is highly likely that this differentiation among the developing countries will become even more pronounced in the future. The risks inherent in the changes in the world economy in the nineties will affect the developing countries to different degrees. In addition to this, only certain parts of the Third World will be able to grasp the opportunities that these changes will also bring. This can be demonstrated by the example of the most important current international economic developments, which are those emanating from the Uruguay Round of GATT, the movement toward the single European market and the regime changes in central and eastern Europe.

The Uruguay Round: To date there has been no agreement reached on any of the major issues of the GATT negotiations, which were scheduled to be completed by the end of 1990. It is likely, however, that there will be a gradual removal of trade barriers and subsidies in the agricultural sector, that the markets for services, especially in the industrialized countries, will be opened up, and that the world trade in textiles will be gradually brought back under the wing of GATT.

Such a result from the Uruguay Round contains short-term risks particularly for the large number of food-importing developing countries. The balance of payments of these countries will be further adversely affected because the world market prices of virtually all major agricultural products will start to rise as soon as dumping, especially by the EC, is prohibited¹⁰. In the medium term, however, the liberalization of trade in agricultural products will offer considerable opportunities. This applies not only to some major exporters of agricultural products, such as Argentina and Brazil, but also to present day food importers which have not hitherto been able to exploit their locational advantages because of artificially low world market prices. Less

distorted relative prices would make domestic food production in these countries more profitable, with the result that the level of self-sufficiency would increase, even to the point of the production of surpluses for export. A pre-condition for this, however, would be that the domestic economic policies of these countries did not undermine such a development.

The economic policies pursued in the developing countries are also crucially important in determining to what extent these countries are able to benefit from trade liberalization in the textiles and service sectors. The countries which will benefit most will be those which are already integrated into the international division of labour and have suitable supply potential available. These are primarily the newly industrializing countries of East Asia and the members of ASEAN, which have thus far suffered most from the Multi-Fibre Agreement¹¹, and which are, furthermore, internationally competitive providers of transport, marketing and engineering services. However, in the longer run, open markets will also contribute to an improvement in the locational advantages of other countries. Producers and investors will no longer suffer from the frequently arbitrary use of emergency clauses in the case of alleged market disruption, which have all too often in the past choked the activities of new suppliers at birth¹².

By contrast, the probable world trade scenario does not offer a favourable outlook for developing countries which are heavily dependent on commodity exports. The decoupling of economic growth in the industrialized countries from raw material consumption will continue in the nineties. It is therefore increasingly necessary for traditional exporters of raw materials to diversify their exports if they want to benefit from the international division of labour. In order for this to happen, far-reaching economic and institutional reforms are necessary.

EC 1992: In the late eighties, the European Community was still (after the US) the second most important export market for the developing countries. This underlines the importance for Third World countries of the integration process in the EC and of the – so far unclarified – future relationship of the EC to non-member states. A particular area of uncertainty is how the considerable differences in the levels of protection of the EC member states will be combined in a common external trade policy, and what effects the single European market will have on the investment behaviour of companies inside and outside the EC.

With these reservations, EC integration (similar to the GATT negotiations) brings with it a series of risks, but also some important opportunities for the future competitive situation of developing countries¹³. Disadvantages could occur as a result of:

- the dismantling of internal barriers in the EC to movements of goods and factors leading to trade diversion to the detriment of third countries;
- trade diversion and relocation of investment to the EC periphery because some EC members, such as Spain, Portugal and Ireland, have a similar factor endowment to many developing countries and benefit from capital subsidies from the well-stocked EC Regional Fund;
- the transfer of national import quotas of vehicles, iron and steel, textiles and some agricultural products (according to Art. 115 to the EC Treaty) to closely monitored Community quotas, which may further restrict the volume of imports of these products;
- newly industrializing countries being graduated out of the Generalized System of Preferences;
- investors from other industrialized countries increasingly concentrating their activities on the EC and possibly cutting back on their investments in other regions.

Such risks should not be overrated, though. Decreasing preference margins of the ACP and Mediterranean countries within the framework of the Generalized System of Preferences are balanced by direct financial transfers – a tendency which has already been reflected in the Lomé IV Agreement. Trade diversification and relocation of investment to the benefit of countries such as Spain and Portugal would quickly be countered by rapidly increasing wage costs on the EC periphery as a result of a European Social Policy (the “Social Dimension”). The same applies in the case of revaluation of the currencies of the capital-importing countries, something which these countries would be very unlikely to be able to avoid, once they are fully integrated into the envisaged European Monetary Union. A massive influx of investment into the EC would induce an appreciation of the ECU and thus improve the relative competitive position of suppliers in developing countries. Moreover, any such influx would be unlikely to be at the cost of foreign investment in developing countries: foreign investment in the EC is increasingly shifting to the service sector, whilst investment in developing countries (oriented toward the national or world markets) is concentrated on manufacturing industries. Finally, the structural change, which the removal of barriers to the free movement of goods and production factors will induce within the EC, offers the opportunity for increasing economic growth well into the nineties. The resulting increase in demand for imports from developing countries is likely to far outweigh the much heralded negative effects of trade diversion. On the other hand, it is true that additional demand is likely to be focussed on competitive suppliers of manufactured goods and services from developing countries in the first place.

Reforms in Eastern Europe: Similar conclusions probably apply in respect of

the effects of the reforms in eastern Europe on the developing countries, although an analytically sound assessment is hardly possible at the present stage¹⁴. It is true that western donors are prepared to give considerable financial support to the reform process in eastern Europe, and the EC has granted its neighbours in the east preferential market access which gives them a status similar to that of EFTA. Nevertheless, in view of the considerable adjustment problems of the COMECON countries, the risks for the developing countries will be kept within reasonable bounds. For example, most goods produced in the reforming countries are not very competitive, from either a price or quality point of view. Hence, the elasticity of exports from these countries will presumably remain fairly low in the short term, even if the necessary economic reforms are consistently implemented. It is unlikely that there will be any significant displacement of exports from developing countries in the near future.

It is also unlikely that creditworthy developing countries will be squeezed out of the international capital market, as there are very tight limits on the access of the East European reforming countries given their existing high indebtedness in hard currency. Furthermore, the absorptive capacity for foreign capital in eastern Europe is limited in the short term. Finally, there are no grounds for believing that there will be a massive shift of foreign direct investment from the developing countries into eastern Europe¹⁵. In view of the infrastructural decay and continuing uncertainties as regards property rights and asset valuation, it is extremely doubtful that there will be an immediate investment boom in the reforming countries. Even if this were to happen, it is unlikely that foreign investors would relinquish attractive locations in the third world, especially in East and Southeast Asia, the centre of growth of the world economy. First evidence suggests that future investment in eastern Europe will be motivated primarily by the intention to penetrate the respective national markets, rather than serving as a platform for exports. Consequently, developing countries with a large market potential and/or locational advantages for world-market-oriented direct investment are unlikely to be negatively affected. On the contrary, eastern Europe offers new market opportunities for them. Moreover, there is a lot of evidence to suggest that European, and particularly German, companies will intensify their involvement in Asian developing countries, where they are currently under-represented in comparison with their American and Japanese competitors¹⁶.

The advanced developing countries of Asia will retain a production and marketing advantage for the foreseeable future. Central elements of the industrial and institutional infrastructure needed to attract foreign investment (e. g. connection to worldwide communications and transport networks, availability of human capital and essential support services) have already been created here.

In other developing countries, however, these increasingly important conditions are still largely absent, and the underlying political and economic conditions are highly uncertain. For them it might prove even more difficult in the future to attract foreign direct investment, given the intensification of worldwide competition for foreign capital.

It can be concluded that the intensive competition among different locations for foreign capital and the fiercer competition on goods markets in the nineties will, in all probability, lead to a further differentiation of the Third World. There is little cause to fear that the relatively advanced Asian developing countries will be pushed onto the sidelines. With few exceptions, they have opened up to the world economy and become successful suppliers of manufactured products and services, and are favoured locations for foreign investors. They will be able to maintain this position in the current decade, if not indeed improve upon it, as the anticipated changes in world economic conditions will create more opportunities than risks for these countries.

However, economic policy failures will become more telling in future and result in even higher economic costs than was the case in the past. The heavily indebted countries of Latin America will therefore rejoin the world economic development and attract foreign capital only through the successful stabilization and structural reform of their economies. This is likely to prove considerably more difficult for the highly indebted countries of Sub-Saharan Africa. There is acute danger that these countries will slide further into economic ruin in the current decade. The decisive factors in this are not so much world economic developments as the continuing high rate of population growth (of round 3-5% p. a.) and the lack of the essential institutional and politico-economic pre-requisites for overcoming the persistent economic weakness. The central problems of these two regions will be highlighted in the following sections. A further point of discussion will be whether and, if so, how development co-operation can help in overcoming these problems.

III. *Structural Adjustment in the Face of Heavy Indebtedness: An Insoluble Dilemma?*

By now it is almost universally accepted that heavily indebted developing countries are under increasing pressure to stabilize their economies and to introduce comprehensive structural reforms. There is also broad agreement on those elements of growth oriented adjustment programmes which are urgently needed. Extensive studies have emphasized the central rôle of fiscal and foreign trade policy¹⁸.

- Chronically high budget deficits are frequently brought about by the struggle of various interest groups for government transfers and subsidies, and in many cases have led to accelerating inflation and the typical concomitant price distortions. What is needed to break this mentality of state alimentation and acceptance of inflation is a revision of tax fiscal and monetary policies. This is all the more the case where the frequently observed overvaluation of the domestic currency requires considerable corrections of the exchange rate, since a real devaluation can bring about additional short-term fiscal problems.
- The superiority of world-market oriented development policies in achieving economic growth and avoiding debt problems has repeatedly been demonstrated. In order to strengthen the export capacity of indebted countries, it is therefore essential to remove any remaining discrimination against world-market oriented activities vis-à-vis activities directed towards import substitution. The priorities here are the abolition of non-tariff trade restrictions, the equalization of effective protection levels amongst the various industries and, finally, the reduction in the average rate of protection.
- Further components of a comprehensive liberalization programme are the easing of restrictions on foreign investment, the strengthening of domestic capital markets by reducing financial repression, and a more efficient organization of the national tax system.

In view of the broad consensus on the essential elements of reform, it may seem somewhat surprising that few debtor countries have thus far implemented any such programme. This can partly be attributed to internal political resistance, which can also be regarded as being a major reason for past failures of economic policy. In addition, there are still controversies about the timing and sequencing of adjustment measures, and on how the problems of economic transition can be overcome¹⁹.

An important reason for delayed adjustment may be the continuing discussion about the form and extent of any debt relief. Measures to ease the burden of debt were granted by official creditors to the least developed debtor countries in the 1988 Toronto Plan²⁰. An explicit debt relief for the major debtor countries, which are mainly in debt to western commercial banks, was first discussed in the Brady Initiative of March 1989. These measures reflect the prevailing view that only immediate concessions on debt servicing will break through the vicious circle of lacking incentives for investment, continuing decline of the debtor countries' ability to pay and a massive withdrawal of lenders.

It is hardly to be disputed that a considerable debt overhang can seriously reduce the incentives to adjust – especially investment incentives – in the

developing countries²¹. The earnings from any additional investment would primarily accrue to the creditors, whilst the debtors would suffer a direct welfare loss because of the necessary cutback in consumption which accompanies investment. Debt relief could have the effect of making further investment more attractive for debtor countries. However, it is highly questionable whether the current strategy of granting the debtors a de facto unconditional debt relief *before* they have taken any economic adjustment measures will lead the way out of the dilemma²². Prior concessions by the creditors, in the form of ex-ante debt relief for countries which have largely brought their payments problems on themselves, not only create moral hazard problems in respect of the future behaviour of debtors which have so far maintained their ability to pay at considerable cost to themselves. They are also likely to reinforce the efforts of the banks to withdraw from their engagement in the developing countries. The central problem of lack of access to new credit would be exacerbated, because if old debts were simply annulled, there would no longer be any incentive for defensive bank lending in order to protect outstanding claims.

Moreover, it cannot be ruled out that debtors will refuse to meet even reduced repayment obligations and continue to avoid the necessary adjustment measures, in spite of assertions to the contrary, if they anticipate advantages from such a course of action. Debtor countries might see a favourable opportunity for the further easing of their debt burden as soon as the creditors signalled their willingness to grant a partial ex-ante relief. The debtors would then seek further concessions in a new round of negotiations instead of putting effort into taking corrective action on their domestic economies. A good reason to expect a reaction of this sort is that an ex-ante debt relief would be likely to strengthen those interest groups which oppose economic reforms for their own self-seeking ends.

It is therefore essential to find some way of easing the burden of debt which reinforces reform incentives for the developing countries, but at the same time avoids the negative effects of an ex-ante relief. One conceivable way would be in a binding commitment of the creditors to reward economic reforms by the debtors *retrospectively* by increased net transfers. The developing countries could then be sure that the inflow of new credit would be sufficient to compensate for their renunciation of any claim for ex-ante debt relief. Credit funds would have to be agreed at the level of new credit requirements, which the creditors would undertake to finance in proportion to their traditional engagement in the countries concerned. Once adjustment measures had been successfully implemented, the debtor country would be able to make immediate claim on the credit fund. In order to avoid any premature termination of promising reform programmes, there would have to be provision made for a

part of the permitted amount of credit to be made available in the difficult transition period.

The financing of the credit funds for developing countries with considerable debt due to commercial banks should be the sole concern of the private creditors²³. The rôle of public authorities would have to be restricted to the creation of favourable conditions for the establishment of rules of international lending, with the clear rejection of any possibility of private losses and risks being taken over by the governments. This also means that the international organizations should concentrate on their traditional tasks of short-term balance of payments financing (IMF) or providing development finance for low-income countries (World Bank), instead of increasingly providing subsidized funds for easing the debts of relatively advanced developing countries: funds which, in the final analysis, primarily benefit the private lending banks. Not until any socialization of private losses is explicitly excluded are both debtors and private creditors likely to give up their wait-and-see attitude: it would become clear to the debtor countries that there is no promising alternative to immediate internal adjustment measures, and private creditors would no longer be able to rely on a state-subsidized escape route from credit relations with developing countries or on official guarantees for new loans.

In addition, the governments of the creditor countries must themselves make a considerable contribution towards improving the prospects of successful economic adjustment by the developing countries, by opening their markets to Third World exports. The creditor countries bear great responsibility for the widespread pessimism in the Third World about the prospects for adjustment and exports. Promises of liberalization by the creditor countries have often been broken. Also in this respect, considerable enforcement problems have to be overcome. At present, neither GATT nor other international organizations are able to impose effective sanctions if a promised liberalization schedule is not adhered to. One possible solution to this would be an agreement to compensate for the failure to open markets by granting additional development assistance; the amount of compensatory aid payments would then be determined by the welfare losses of the debtor countries resulting from the retained protection measures. Remaining enforcement problems would be easier to overcome if, for instance, compensatory aid payments could be decided upon under the auspices of the World Bank – using a voting system different from the usual weighted system prevailing – in accordance with the principle of “one country – one vote”, as soon as a violation of the agreed liberalization schedule was notified by GATT. The maximum amount which could be distributed under this voting procedure would be given by the estimated welfare loss of the developing countries resulting from the failure to implement liberalization.

IV. *New Directions for Development Co-operation: A Way Out of Africa's Malaise?*

If measures for easing the burden of debt are arranged in such a way that they do not make internal adjustment efforts seem superfluous, but encourage and provide financial back-up for reforms, then the economic difficulties of developing countries with considerable – but currently stifled – development potential could be relatively quickly overcome. In countries where the basic pre-conditions for lasting economic recovery are largely non-existent, this is likely to be a good deal more difficult. Especially in the case of Sub-Saharan Africa, the choice must be made, in the framework of development co-operation, as to whether this region is persistently to be treated as an international social security case into which vast sums of development aid continue to be pumped, even though there is clearly no sign of any positive macro-economic growth effects having been achieved in this way.²⁴ Alternatively, future foreign aid might be concentrated on facilitating the creation of the basic pre-conditions for economic development, with aid being linked to appropriate actions by the recipient countries.

If the second option is chosen, then the first essential will be to recognize the unadorned reality of the causes of Africa's enduring malaise²⁵. The increasing inability of most countries in this region to adjust to changing world economic conditions can be traced back to policy-induced inflexibility of production and exports, to market-fragmentation with a lack of spillover between sectors, to the inefficiency of the large number of state enterprises and to a level of state intervention in private markets which borders on state economic management, but with a simultaneous decline of public administration. The traditional structural adjustment programmes of the IMF and the World Bank are hardly likely to be of any use as long as the politico-economic factors which dominate the decision-making processes in Sub-Saharan Africa remain unchanged. The fundamental problems lie in the amassing of power by parasitic élites (personal rule) and the enrichment of non-productive state classes, the divisions in many countries between the various tribes, political instability characterized by political violence and border conflicts, and uninterrupted population growth.

It is impossible to solve these problems from outside. Without internal political, institutional and economic reforms, development aid, however high it might be, is doomed to failure. In particular, external aid can be no substitute for sound macro-economic management and a domestic incentive system which promotes economic diversification and market integration. External aid could, however, support the implementation of reforms and the stabilization of the fragile institutional framework, if it follows the subsequent guidelines²⁶:

- *Selectivity*: Apart from emergency aid, development assistance should no longer be granted to governments which prove to be notoriously unwilling to undertake internal reforms.
- *Premium approach*: Efforts by the recipient countries to implement domestic reforms should be recognized more than previously by increased development aid. Evidence suggests that promising reform programmes in Sub-Saharan Africa have failed or been abandoned because of inadequate support from the donor countries²⁷. Reform projects should not, however, be rewarded simply on the basis of declarations of intent, since letters of intent have frequently turned out to be inadequate proof of the willingness to undertake reforms.
- *Flexibility and credibility*: The principles so far listed require greater flexibility in the distribution of development aid amongst low-income countries. At the same time, there must be greater transparency in the allocation of aid, for instance by the publication of country and feasibility studies, in order to clarify the development orientation of donor policy for the recipients, and to strengthen the credibility of aid in the donor countries.
- *Software orientation*: As the essential barriers to development in low-income countries are to be found in politico-economic and institutional factors, aid should be concentrated on institution building, developing human resources, controlling population growth, and on other areas of poverty alleviation. Aid in the sphere of the physical infrastructure and direct support of sectoral diversification should no longer be treated as priorities.

These fundamental principles point to various areas in which future development co-operation can be concentrated. The success of any attempts at reform in Sub-Saharan Africa will particularly depend on the mobilization of internal support, the free exchange of information on government behaviour, the establishment and enforcement of individual property rights, and the mobilization and mobility of human and financial resources on a national and intra-regional level. Foreign aid should therefore contribute toward the easing of access to information and facilitating the articulation of hitherto suppressed interest groups. Measures aimed at establishing and protecting the freedom of expression and of the press, disseminating economic information and organizing producers' and consumers' interests should be supported. Another important point in the area of institution building would be to provide assistance in the definition and implementation of property rights. One way of achieving this would be through technical and financial aid in the establishment of independent courts and administrative offices (e.g. land registry offices). Foreign donors should also support the setting-up of efficient private capital

markets. If third world governments are willing to permit financial deregulation, then there will be a need for assistance in areas such as accounting and lending procedures, the development of an adequate branch network of financial institutions and the introduction of financial innovations and stock exchanges.

The prime needs in the area of human capital formation are primary education and vocational training in order to increase labour productivity on the one hand, and to change the generative behaviour of the population in the long term on the other. Foreign aid can include the development of appropriate curricula, teacher training and the provision of teaching resources. Further education should concentrate on managerial skills and marketing knowhow, on processing technologies and national as well as intra-regional research activities in the raw materials field. The latter could also help combat the much bemoaned brain drain.

The industrialized countries also have an important part to play in helping overcome internal resistance to reform in low-income countries. Export pessimism is even more widespread in Sub-Saharan Africa than in Latin America. Free Access to OECD markets is therefore an important element in ensuring the credibility and sustainability of any reform projects. Despite a range of preferences for low-income countries (such as the Lomé Convention and the GSP), there is still a need for action as regards the liberalization of the import practices of the industrialized countries²⁸. In particular, non-traditional exports are discouraged by restrictive rules of origin, the threat of import quotas and tariff escalation, i.e. tariffs increasing with the level of processing. In the case of traditional commodity exports, the existing systems for stabilizing export *earnings* (STABEX, IMF) should be improved. Compensatory financing can provide an effective alternative to the largely unsuccessful commodity agreements only if the compensation for losses of export earnings caused by unfavourable world market developments is granted without delay, and the stabilization systems are adequately funded.

A further factor which gives rise to internal opposition to reform is that of the short-term costs which necessarily result from adjustment programmes for certain segments of the population. Even a strongly reform-minded government will come under great pressure in the difficult transition period, especially if – as can be anticipated in most low-income countries – there is a considerable lag in the reaction by producers and investors to changed relative prices. Foreign aid can at least alleviate the problems of transition. However, budgetary support and compensation payments should be tied to progress in the reduction of government deficits by means of cuts in subsidies, the slimming down of an overstuffed bureaucracy and the privatization of state enterprises. One possibility, for example, would be to encourage the necessary

devaluation of national currencies by agreeing to calculate foreign debt liabilities on the basis of historical exchange rates. This would avoid additional fiscal problems arising from increased debt servicing requirements in terms of national currency in the aftermath of a devaluation. Further alleviation of the debt burden to reward progressing internal adjustment could be achieved by postponing, or even forgiving, debt repayments. On the revenue side of government budgets, there is urgent need for technical assistance in reforming tax systems and in setting-up efficient tax and customs administrations in order to keep fiscal problems within bounds.

Occasional compensation payments are likely to be needed primarily for the particularly poor segments of the population. In the transition period of structural reforms, the income and nutritional status of the poor can further deteriorate, as a result of increasing food prices and decreasing subsidies, before positive income and employment effects materialize. However, food security programmes must be arranged in such a way that migration to urban areas is halted, and incentives to increased national food production are not undermined as has been the case in the past. Temporary food aid should therefore be concentrated on rural areas and targeted on needy groups by means, for example, of "food for work" programmes. On the other hand, an immediate end must be made to the regular shipping of the industrialized countries' food surpluses from their own self-serving motives, because of the damaging effects of this so-called food aid on production incentives in developing countries.

A final area of anti-poverty measures are those providing external support for environmental protection. Environmental policy has become increasingly focussed on the significant deforestation of tropical rain forests²⁹, because of the environmental damage resulting from it. In poor and heavily indebted countries, the natural resources are frequently undervalued assets, and the longer-term exploitation costs are postponed to future generations. If the industrialized countries – having seriously damaged the environment in their own areas – now wish to persuade the developing countries to include the external costs of the utilization of environmental resources in their economic calculations, and to keep global environmental problems in bounds by reduced exploitation, then it is up to the advanced economies to balance out the short-term loss of income which such policies would bring.

There are various options for achieving this, the effectiveness of which is largely dependent on the economic reasons for the utilization of the environmental resources. The clearance of rain forests serves, on the one hand, to create new arable land and pasture and to enable access to mineral reserves. On the other hand, for many developing countries tropical wood is an important resource for domestic energy production and for export. Clearance therefore

involves strong linkages and may serve different purposes at the same time. Any proposals to solve the problem which ignore this fact can be only of limited use. This particularly applies to the demands, which can be heard from many directions, for bans on the import of tropical wood. These would lead to a significant reduction in deforestation only in cases where exports account for a sufficiently high share of the economic utilization of the tropical wood. In many developing countries – particularly in Brazil – this is not the case³⁰. Furthermore, the overall trade effects would be uncertain unless all consumer countries – including many developing and newly industrializing countries – joined in a boycott. Finally, the export of tropical wood would simply be supplanted by internal use or burning as long as the earnings from the other uses (e.g. agriculture and mining) remain positive.

There is also little likelihood of the “debt for nature” swaps proving any more effective. The proponents of these swaps aim to reduce the export pressure resulting from heavy indebtedness by granting countries with rain forests a reduction of their foreign debt in return for guarantees that the natural resources will be conserved. This proposal, too, neglects the fact that the majority of destruction of the rain forests is attributable to domestic demand for an indigenous energy source, and to burning. Debt reduction would presumably remove only a small proportion of the incentives to cut down the rain forests. The single-track orientation of these swap-linked transfer payments towards reducing the burden of debt would, moreover, put countries without any serious debt problem, such as Malaysia, Thailand and Indonesia, at a disadvantage. Thus, with increasing world market prices for tropical wood, these countries might further increase the speed with which they are cutting down the rain forests. Finally, experiences with the comparable debt-equity swaps point to various macro-economic problems associated with debt swaps³¹. One particular problem is the possible creation of additional fiscal problems, since the reduction of foreign debt is frequently accompanied by increasing domestic borrowing by the government, in some cases resulting in even higher interest obligations.

There are therefore many arguments in favour of the countries affected by the external costs of deforestation making *direct* transfer payments to countries with rain forests in order to persuade them to protect their natural resources. The necessary level of transfers would be determined by the opportunity costs of reduced exploitation of the rain forests in the developing country concerned, and by the world-wide costs of the environmental damage which would result from deforestation³². The details of any such transfer agreement would have to be worked out on the political level. The enforcement of such agreements – especially as regards the reduction in the utilization of environmental resources agreed to by the developing countries – would be made easier

if the transfers were paid in instalments rather than as single lump sum payments. In this way it would also possibly be easier to ensure that the transfer payments were primarily used to benefit the particularly poor segments of the population which would have to bear the brunt of the ban on resource utilization.

V. Development Co-operation in the Nineties: A Resumé

The problems facing the developing countries in the early nineties mean that there is more necessity than ever for domestic economic restructuring. Foreign aid cannot be a substitute for comprehensive and consistent reforms. The best that development co-operation can achieve is to increase the credibility of reform efforts, alleviate any problems of implementation and enforcement and improve the chances of success.

Failures of economic policy in the developing countries will be of greater consequence in the future. Foreseeable developments on the international economic front will lead, at least in the long term, to more intense worldwide competition for foreign capital and increasingly keen competition in the goods markets. There are wide differences in the extent to which the developing countries are equipped to avoid the accompanying risks, and grasp the opportunities which the worldwide structural changes offer. The disparities between countries within the Third World will therefore continue to widen.

In this situation, it is of the utmost importance that development co-operation does not continue to reinforce the pessimism of many developing countries about their capability of economic adjustment, but effectively combats this view. On the one hand, this requires the industrialized countries to keep their markets open, and even widen access, to exports from developing countries. The EC has a particular responsibility in this respect. It must convince the developing countries that the 1992 European project will not degenerate into a "Fortress Europe". The success of the Uruguay Round in achieving greater liberalization is also largely dependent on the behaviour of the EC (especially on agriculture). On the other hand, it is important to ensure the credible and predictable provision of development aid in order to dissipate the current fears of the recipient countries that they will no longer receive adequate support in view of the financing requirements of the East European reforming countries. External financing of the relatively advanced countries of eastern Europe out of public funds should be kept to the minimum.

Development co-operation has only a limited part to play in solving the debt problems of the relatively advanced developing countries. Where debt relief is necessary and meaningful, a method should be found which reinforces reform

incentives for the debtor countries. Development co-operation must ensure that private losses and risks are not underwritten by the creditor governments. Not until there is a clear rejection of efforts aiming at socialization by both debtors and private creditors will the right conditions be created for a market-oriented solution of the debt and incentive problems of these countries. The international financial institutions should restrict their activities to their traditional rôles of financing short-term balance of payments problems, development financing for low-income countries and providing an economic advisory service.

In the case of the low-income countries, foreign aid should, in the future, be concentrated on facilitating the laying of firm foundations for economic development, if these countries are not to be finally written off as a world social security case. There is no way that the fundamental politico-economic problems of these countries can be solved from outside. However, where genuine willingness for reform has been demonstrated, foreign aid can support the implementation of reforms and the stabilization of fragile institutions. Aid here should be concentrated on institution building, the development of human resources, the control of population growth and the fight against poverty. It should contribute toward overcoming internal resistance to the necessary reforms and to alleviating the short-term burdens of adjustment on the particularly poor segments of the population.

NOTES

* Paper presented at the Conference of the Working Party on European Integration: "Is there a New Emphasis in Relations between the EC and Third World Countries?" Hamburg, 11th – 13th October 1990.

¹ A survey is given in: Bundesministerium für wirtschaftliche Zusammenarbeit (BMZ), Achter Bericht zur Entwicklungspolitik der Bundesregierung. (Federal German Ministry of Economic Co-operation. Eighth Report on the Development Policy of the Federal Government). Bonn May 1990.

² According to World Bank estimates, this applied to almost 1 billion people in mid 1988.

³ Cf. e.g. Schreiber, Helmut: "Debt-for-Nature Swap" – ein Instrument gegen Verschuldung und Umwelterstörung. Institut für Europäische Umweltpolitik (Institute for European Environmental Policy), Frankfurt a. M. July 1988.

⁴ Nominal commodity prices, quoted in US Dollars, fell by a quarter between 1980 and 1987. This considerably worsened the terms of trade for the commodity-exporting developing countries, since the prices for imports of finished goods increased by 30% just between 1985 and 1987.

⁵ New bank loans to developing countries fell from almost \$50 bn. in 1980 to \$5 bn. in 1988.

⁶ Alworth and Turner summarize as follows: "During the decade 1975-84, between one third and one quarter of direct investment was directed to the

developing world. . . . By 1989 aggregate inflows into developing countries were less than one-tenth the flows into developed countries. The 'true' picture was even bleaker for most developing countries as a significant and increasing proportion of direct investment flows went to offshore centres" – Alworth, Julian S. – Philip Turner: *The Global Pattern of Capital Flows in the 1980s*. Paper presented at the 1990 Kiel Week Conference "Capital Flows in the World Economy", Institut für Weltwirtschaft (Institute of World Economics), mimeo, p. 8.

⁷ On the political economy of stabilization and structural reform programmes, cf. Haggard, Stephan – Robert Kaufman: *The Politics of Stabilization and Structural Adjustment*, in: Sachs, Jeffrey D. (ed.), *Developing Country Debt and Economic Performance*. Vol. 1: *The International Financial System*. Chicago, London 1989; pp. 209-254.

⁸ On the following, in more detail, cf. Hiemenz, Ulrich: *Vision für die neunziger Jahre: Die Entwicklungsländer auf dem Abstellgleis?* Institut für Weltwirtschaft, August 1990 (mimeo).

⁹ Cf. e.g. Nunnenkamp, Peter: *Krisenanpassung in Ostasien und Lateinamerika*, in: *Jahrbuch Dritte Welt 1985*, Munich 1985; pp. 87-100. The differentiation amongst the developing countries is also clearly demonstrated in the following data (cf. eg. World Bank, *World Development Report 1990*; BMZ op. cit.): 1) Between 1980 and 1989 there was a decrease in real per capita GDP in Sub-Saharan Africa (-2.2% p. a.) and Latin America (-0.6%). By contrast, incomes rose more rapidly in East Asia (6-7% p. a.) than previously, and considerably faster than in the industrialized countries. 2) The newly industrializing countries, particularly in Asia, were able to further expand their share in world trade, whilst the poorest countries, especially in Africa, fell even further behind. 2) Since the onset of the debt crisis, the problem debtors, mainly in Latin America, have been largely cut off from the inflow of fresh capital, whilst countries without serious repayment problems continue to have access to the international capital markets (on details, cf. Nunnenkamp, Peter: *Kapitalabflüsse aus der Dritten Welt und Schuldenerlass: Zu den Problemen des privaten Kapitaltransfers zwischen Industrie- und Entwicklungsländern*. Kieler Diskussionsbeiträge, No. 139, June 1988). Consequently, any concept of a homogeneous bloc of developing countries is less apposite now than at any time.

¹⁰ Cf. Tyers, R. – K. Anderson: *Liberalizing OECD Agricultural Policies in the Uruguay Round: Effects on Trade and Welfare*, *Journal of Agricultural Economics*, Vol. 39 (1988); pp. 197-216.

¹¹ Cf. Spinanger, Dean: *Is the EC Foreshadowing a Fortress Europe in 1992? Examining Implications of 1992 and Current EC Trade Restrictions for PACRIM Countries*, *PRICES Paper*, No. 1 Hong Kong July 1989.

¹² On the example of Bangladesh, cf. Spinanger, Dean: *Will the Multi-Fibre Arrangement Keep Bangladesh Humble?*, *The World Economy*, Vol. 10 (1988), pp. 75-84.

¹³ Detailed analyses can be found in: Langhammer, Rolf J.: *Auswirkungen der EG-Binnenmarktintegration auf den Aussenhandel der Entwicklungsländer*. Kieler Arbeitspapiere, No. 369, May 1989; Hiemenz, Ulrich, et. al.: *European Trade Policies towards Developing Countries*, Kiel 1990 (in preparation for publication).

¹⁴ On first attempts in this direction, cf. OECD, *Economic Outlook*, No. 47, Paris 1990; pp. 47-52.

¹⁵ On this, cf. UNIDO: *Foreign Direct Investment Flows to Developing Countries: Recent Trends, Major Determinants and Policy Implications*. PPD. 167, Vienna, July 1990; espec. p. 15.

¹⁶ Cf. Agarwal, Jamuna P.: *Europäische Direktinvestitionen in Ostasien – Ein internationaler Vergleich*. *Die Weltwirtschaft*, 1988; No. 1, pp. 138-149.

¹⁷ Cf. also UNIDO, op. cit.

¹⁸ Cf. e.g. Sachs, Jeffrey D. (ed.): *Developing Country Debt and Economic Performance*. Vol. 1: *The International Financial System*, Chicago, London 1989; Sachs, Jeffrey D. (ed.): *Developing Country Debt and the World Economy*, Chicago, London 1989.

¹⁹ Particularly at issue is whether structural reforms should be carried out only after macro-economic stabilization has been achieved. To postpone liberalization measures is proposed e.g. by Sachs in the above cited works. This comes as something of a surprise, in view of the earlier criticism of the approach of the IMF which, in the initial phases of the international debt management, leaned virtually exclusively on short-term stabilization, and which at that time was rightly accused of neglecting growth-promoting measures of structural adjustment (on this, cf. Nunnenkamp, Peter: *The Deadlock in Dealing with Developing Country Debt: A Review*". *Weltwirtschaftliches Archiv*, Vol. 126 (1990), pp. 791-798).

²⁰ At the 1990 autumn conference of the IMF and World Bank in Washington, it was suggested to extend the level of debt relief for this group of countries.

²¹ On this, cf. e.g. Krugman, Paul: *Financing versus Forgiving a Debt Overhang*. NBER Working Papers, No. 2486, Cambridge (Mass.) 1988; Sachs, Jeffrey D.: *Conditionality, Debt Relief and the Developing Country Debt Crisis*, in: Sachs (ed.), *Developing Country Debt and Economic Performance*, op. cit., pp. 255-295.

²² On the following, in more detail, cf. Nunnenkamp, Peter – Volker Stüven: *Wirtschaftsreform, Schuldenerlass und Souveränitätsrisiko*. *Zum Problem fehlender Investitionsanreize*. *Kieler Arbeitspapiere*, No. 410, January 1990; Nunnenkamp, Peter: *Cui Bono? Zur Forderung nach einem Schuldenerlass*. *Freiburger Universitätsblätter*, Vol. 29 (1990), No. 110, pp. 45-53.

²³ An analogous system of credit funds should also be created by official creditors for those developing countries whose repayment problems primarily relate to development aid loans. For these countries, too, an alternative system should be created to the de facto unconditional ex-ante debt relief.

²⁴ There is comprehensive empirical evidence on this in: Agarwal, Jamuna P. et. al.: *Wirkungen der Entwicklungshilfe*. *Bestandsaufnahme und Überprüfung für die zweite Entwicklungsdekade*. *Forschungsberichte des Bundesministeriums für wirtschaftliche Zusammenarbeit*, Vol. 50, Munich 1984.

²⁵ On this, cf. World Bank: *Beyond Adjustment: Toward Sustainable Growth with Equity in Sub-Saharan Africa*. *Technical Report, Part II*, Washington 1988; Hiemenz, Ulrich: *Development Strategies and Foreign Aid Policies for Low Income Countries in the 1990s*. *Kieler Diskussionsbeiträge*, No. 152, August 1989.

²⁶ In more detail, cf. Hiemenz: *Development Strategies*, op. cit.

²⁷ Cf. Gulhati, Ravi – Raji Nallari: Reform of Foreign Aid Policies: The Issue of Inter-Country Allocation in Africa. *World Development*, Vol. 16 (1988), pp. 1167-1184.

²⁸ For details, cf. Agarwal, Jamuna P. et al.: *EC Trade Policies towards Associated Developing Countries: Barriers to Success*. Kieler Studien, No. 193. Tübingen 1985.

²⁹ Cf. Amelung, Torsten: Zur Rettung der tropischen Regenwälder: Eine kritische Bestandsaufnahme der wirtschaftspolitischen Lösungsvorschläge. *Die Weltwirtschaft*, 1989; No. 2, pp. 152-165.

³⁰ Cf. Burger, Dietrich: Tropenholzboykott und technische Zusammenarbeit. *GTZ Info*, 1989, No. 4, Frankfurt, pp. 19-23.

³¹ Cf. e.g. Huss, Hans-Joachim – Peter Nunnenkamp: Finanzinnovationen und Schuldenerlass – Wege zu einem effizienteren Management der Auslandsschulden von Entwicklungsländern?. *Die Weltwirtschaft*, 1987; No. 2, pp. 110-125.

³² Cf. Amelung, op. cit.